

Docket:	:	<u>A. 06-02-014</u>
Exhibit Number	:	<u></u>
Commissioner	:	<u>Bohn</u>
Admin. Law Judge	:	<u>J. Vieth</u>
DRA Witness.	:	<u>Cleason D. Willis</u>
	:	<u></u>



**DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION**

**Report On the
Cost of Capital
For
San Jose Water Company**

**Test Year 2007
Application 06-02-014**

**San Francisco, California
June 2006**

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**CHAPTER 1: INTRODCUTION AND SUMMARY OF
RECOMMENDATIONS**

This report contains the recommendations of the Division of Ratepayer Advocates (DRA) regarding the estimated average rate of return for the years 2007 through 2009 for San Jose Water Company (San Jose) in connection to A. 06-02-014. DRA recommends a rate of return (ROR) for San Jose of 8.65% for Test Year 2007 and 8.63% for the attrition years 2008 and 2009. This return compares to the ROR requested by San Jose Water of 9.46% for 2007, and 9.44%, for 2008 and 2009. As reflected in Table 1-1, DRA recommends 9.65% for the return on equity (ROE). San Jose Water is requesting 11.20% for its ROE for 2007 through 2009. For debt, DRA accepts San Jose Water’s requested cost of debt which consists of 7.54%, 7.52%, and 7.52% for 2007, 2008, and 2009 respectively. See Table 1-1 for a comparison of the company’s requested and DRA’s recommended rate of return and capital structure.

			Table 1 -1					
			San Jose Water Company					
		Comparison of Requested and DRA Recommended						
			Cost of Capital & Capital Structure					
			Cost of Capital 2007 thru 2009					
			San Jose Water Company Requested:			ORA Recommended:		
		Capital	Cost	Weighted		Capital	Cost	Weighted
		Structure	Factor:	Cost:		Structure	Factor:	Cost:
2007								
Long Term Debt		47.53%	7.54%	3.58%		47.53%	7.54%	3.58%
Common Equity		52.47%	11.20%	5.88%		52.47%	9.65%	5.06%
Total		100.00%		9.46%		100.00%		8.65%
'2008								
Long Term Debt		47.86%	7.52%	3.60%		47.86%	7.52%	3.60%
Common Equity		52.14%	11.20%	5.84%		52.14%	9.65%	5.03%
Total		100.00%		9.44%		100.00%		8.63%
'2009								
Long Term Debt		47.86%	7.52%	3.60%		47.86%	7.52%	3.60%
Common Equity		52.14%	11.20%	5.84%		52.14%	9.65%	5.03%
Total		100.00%		9.44%		100.00%		8.63%

CHAPTER 2: QUANTATIVE ANALYSIS

A. INTRODUCTION

The market's required return on equity is not directly observable. Implicit in stock prices, however, is investors' expected returns. Analytical techniques based on finance theory have been developed to infer the return on equity from stock – price data. DRA uses two financial models – Discounted Cash Flow (DCF) and Risk Premium (RP) – to estimate investors' expected ROE for San Jose Water Company (San Jose Water). The Tables referred to in this chapter are located at the end of the chapter.

B. DISCUSSION

1) Comparable Group

DRA has determined a range of ROE's for San Jose Water by applying the DCF and RP Models to a group of comparable water utilities. Results derived from the DCF may be biased and less reliable when applied to a specific company, such as one with unusually high or unusually low dividend growth rates. Applying the DCF and RP Models to a larger sample, such as DRA's comparable group, serves to correct such biases. DRA chose six utilities as the comparable group using the following criteria: (1) water operations that account for at least 70% of the utility's revenues and (2) the utility's stock is publicly traded. See Table 2-1.

On occasion, some water utilities have rebutted the use of staff's data and models by taking individual components out of context to supposedly illustrate that staff's results are not reasonable. Since staff bases its recommended ROE on an average of results using various components (all described in the following

discussions) taking an individual component and calculating the models in such a “vacuum” is incorrect and proves nothing. This ‘recalculation’ of staff’s data is improper and cannot be applied to the results calculated in this report.

2) Discounted Cash Flow Model (DCF)

The DCF Model reflects the current market price of a share of common stock equal to the present value of the expected future stream of dividends and the future sale price of a share of stock, discounted at the investor’s discount rate. The expected rate of return is expressed by the discount rate that equates the market price of the stock to the present values of the flow of cash receipts. The DCF Model solves for the investor’s discount rate as follows:

$$R = D1/Po + g,$$

Where:

R = the investor’s expected return on equity,

D1 = the expected dividend in the next period,

Po = the market price in the current period, and

g = the expected future dividend growth rate.

3) Dividend Yield

The dividend yield depends on next year’s dividends per share and the current stock price. The next year’s expected dividend yield, $D1 / Po$, can be estimated by multiplying the current dividend yield, Do/Po , by one plus the expected growth rate “g”. DRA has also adjusted the dividends to account for quarterly compounding; in order to account for the time value of money. DRA used the 90 day commercial paper rate of 4.90% (March/2006) to account for the future value of these quarterly dividends.

Table 2-2 shows the current annualized dividend yield for the comparable group. The average yield is 2.73% over the most recent three month period of February of 2006 to April of 2006, 2.85% for the most recent six-month period of November of 2005 through April of 2006, and 2.88% for the most recent 12-month period of May of 2005 through April of 2006. Three different periods are used in order to mitigate period specific biases and to consider both current and long-term trends.

4) Growth Rates

The DCF Model assumes that dividends grow at a constant rate, g , and continue growing at that rate for the foreseeable future. In order to balance the historical and forecasted growth rates, DRA examined three types of growth rates to estimate future dividend growth: (1) historical dividend and earnings growth rates, (2) sustainable growth rates, and (3) a forecast of earnings growth rates for the comparable group of companies.

5) Historical Growth Rates

(a) Earnings and Dividend Growth

Historical Growth rates can provide a useful indication about future growth when past conditions can be reasonably expected to continue. Table 2-3 shows the average historical earnings and dividend growth rates of the comparable group for the period 1996 through 2005, with both five and ten year averages. Even though dividend per share growth is preferable, since an exact correlation can be made to other components in the DCF Model (dividends are part of the dividend yield calculation), earnings are necessary to generate dividends, so earnings growth is also included in this analysis.

Concerns have been raised in other cases that the historical growth rates used by DRA are not similar to those being forecasted. Therefore the historical growth rates are not indicative of future growth. One only has to look at the historical

1 average earnings growth rates listed on Table 2-3 to see that the forecasted
2 average earnings on Table 2-4 are within a relative range. If one was to look at
3 DRA's work papers that support Table 2-3, one would see even more individual
4 company historical growth rates that are within the range of forecasted growth
5 rates and higher.

6 The average historical five and ten year earnings growth rates are 5.15% and
7 4.90%. The average historical five and ten year dividend growth rates are 2.44%
8 and 2.37%. (See Table 2-3).

9 **6) Sustainable Growth**

10 The expected future growth rate can also be measured by examining the
11 sustainable growth rate, which is equal to the product of the retention ratio and the
12 book return on equity. Growth in earnings and, dividends can only be sustained if
13 a portion of the earnings is reinvested by the company. DRA calculates
14 sustainable growth per the method discussed in the The Cost of Capital –
15 Estimating the Rate of Return for Public Utilities,¹ which states that sustainable
16 growth is measured as “The rate of return on book equity, ROE, times the
17 proportion of earnings that is retained within the firm, ...instead of being paid out
18 as dividends...The sustainable growth rate, ...was calculated by multiplying the
19 five-year average book return on equity by the earnings retention rate (the
20 retention rate is one minus the dividend payout rate).”² In the above referenced
21 book, the authors also discuss the possible use of issuance cost in the

¹ The Cost of Capital-Estimating the Rate of Return for Public Utilities, by A. Lawrence Kolbe and James A. Read Jr., with George R. Hall, 1985.

² Ibid., pages 55 and 99.

1 determination of the return on equity. This is not included by DRA because in D.
2 92-11-047, this Commission rejected the use of issuance cost in the determination
3 of the ROE.³

4 The group's average five-year sustainable growth rate is 2.36% and the ten-
5 year sustainable growth rate is 2.45% (Table 2-3).

6 **7) Overall Historical Growth**

7 Based on the average historical earnings, dividend, and sustainable growth
8 rates, the overall average historical growth is 3.28%.

9 **8) Forecasted Growth Rates**

10 DRA also considered several forecasted earnings growth rates, including
11 Zack's, First Call (for this case it wasn't available), S&P (for this case it wasn't
12 available), Valueline, and Multex, as shown on Table 2-4. DRA took a weighted
13 average of the forecasts, based on the number of companies for which each
14 organization provides a forecast.⁴ This overall weighted average is 7.86%.

³ “the drop in the market price upon a new issuance may be only temporary and be erased by a subsequent price rise and that, in practice, some new issuance's cause price rise” (D.92-11-047, p.85). “floatation adjustment is inappropriate as long as utility stocks are trading significantly above their book value” (D.92-11-947, p. 86).

⁴ DRA weights the average of each forecaster by taking the number of its data points, dividing by the total number of data points, and then multiplying this by the average. This operation is performed for each column, then totaled to determine the overall weighted average of the forecasts.

9) Conclusion – Growth Rate

Based upon the above discussion, DRA has determined an average growth rate of 5.57%.⁵ (See Table 2-4).

10) Results of DCF Model

The results of the DCF Model using data from the comparable group are summarized in Table 2-5. Based on current dividend yields (Table 2-2) and an expected overall growth rate of 5.57%, the expected three month dividend yield for the comparable group is 2.88%, the expected six month dividend yield is 3.01%, and the expected twelve month dividend yield is 3.04%. Combining the expected three, six, and twelve month yields with the expected growth rates produces expected returns on equity of 8.45%, 8.58%, and 8.61%, with an average of 8.55%. (See Table 2-8).

11) Risk Premium Model (RP)

The Risk Premium Model recognizes that investors have different requirements regarding risk and return for common stocks as compared to bonds. The RP equation is written as follows:

$$K_t = k_d + RP,$$

Where K_t is the cost of equity, k_d is the cost of debt, and RP is the Risk Premium.

This model is based upon the assumption that investments in common stock are riskier than investments in long – term debt, since stockholders are but residual claimants to earnings and assets in the event of liquidation. As a result, investors

⁵ Average of the Average Historical Growth rate of 3.28% and Average Forecast Growth Rate of 7.86% results in an average growth rate of 5.57%.

1 holding common stock expect higher returns. In order to develop the required
2 return on equity, this greater risk is stated as a premium, which is added to the
3 estimated cost of long-term debt. As a result of the variance in historical
4 premiums, an average risk premium is calculated over an extended period of time,
5 five and ten years in this case.

6 DRA applied the RP Model to the same comparable group used in the DCF
7 model in order to determine the appropriate return on equity for San Jose Water.
8 DRA used historical earned ROE's for the comparable group in order to estimate
9 the stockholder's expected return on equity. These returns are easily accessible to
10 the investor (annual reports and financial web sites) and require no computation.
11 An alternative is to use the authorized ROE, but this has not been considered by
12 DRA, because authorized ROE is not always an accurate measure of what is
13 expected by investors. The authorized ROE can be distorted by the effect of
14 settlements (the ROE could be inflated, or deflated to account for trade-offs in
15 other areas of a settlement). The annual yields on 10 – year and 30 – year
16 Treasury bonds were subtracted from the comparable group's average returns on
17 equity for each year to determine the annual risk premium.

18 (a) Results of Risk Premium Model

19 Table 2-6 presents forecasted interest rates for the test period, taken from
20 Data Resources Inc. (DRI) report for April 2006. DRI has consistently been
21 accepted by this Commission for use in determining a cost of capital.⁶ For the
22 period of 2007 to 2009, the average forecasted rate for 10 – Year Treasury bonds
23 is 5.18%, and the average forecasted rate for 30 – Year Treasury bonds is 5.37%.

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⁶ 38 CPUC 2nd at page 238 and 46 CPUC 2nd at pages 319, 360 – 361.

1 Table 2-7 provides the results of the Risk Premium Model for DRA's
2 comparable group. The average premiums are 5.65% and 5.20% for the ten-year
3 period and 5.88% and 5.20% for the five-year period, based upon 10-year
4 Treasury bond yield and the 30-year Treasury bond yields, respectively.

5 DRA calculated an expected return on equity of 10.83% for the 10-year
6 Treasury bond yield and 10.57% for the 30-year Treasury bond yield. Using the 5
7 – year risk premiums produced expected returns of 11.06% for the 10-year
8 Treasury bond yield and 10.57% for the 30-year Treasury bond yield. Combining
9 these results, DRA calculated an average ROE of 10.76%. (See Table 2-8).

10 **12) San Jose Water Company-Capital** 11 **Structure**

12 San Jose Water Company has proposed a capital structure consisting of long-
13 term debt, and common stock. San Jose's Water's projected common equity ratio
14 for the years 2007 – 2009 averages 52.25% which is higher than the comparable
15 groups' average of 49.45%. The company's proposed long-term debt ratio for the
16 same period averages 47.75% which is lower than the comparable group average
17 of 49.99%. See Table 2-1. DRA has reviewed San Jose Water's proposed capital
18 structure and has determined that it is reasonable. See Table 1-1 of this report.

19 **13) Summary of Model Results**

20 Table 2-8 summarizes the results of the DCF and RP Models. The two models
21 used to derive the return on equity indicate a return on equity within the range of
22 8.55% to 10.76%. Averaging the results of the financial models produces an
23 expected return on equity of 9.65%.

					Table 2 - 1		
					San Jose Water Company		
					Summary of Equity and Long-Term Debt Ratios		
					For DRA's Comparable Group of Companies		
Companies:			Equity Ratio:		Debt Ratio:		
American States Water			48.00%		52.00%		
California Water Service Co. /			51.06%		48.40%		
Connecticut Water Service			57.00%		43.00%		
Middlesex Water Service /1			44.00%		53.77%		
Philadelphia (Aqua American)			47.20%		52.80%		
Comparable Group Average:			49.45%		49.99%		
San Jose Water Co. Average Equity and Debt							
Ratio for 2007 through 2009:			52.25%		47.75%		
1/ Has Preferred Stock							

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		Table 2-2					
		San Jose Water Company					
		Current Annualized Dividend Yield					
		Comparable Group					
		3-Month		6-Month		12-Month	
		Dividend		Dividend		Dividend	
		Yield		Yield		Yield	
American States Water		2.50%		2.73%		2.88%	
California Water Service		2.61%		2.79%		2.91%	
Connecticut Water Service		3.34%		3.46%		3.47%	
Middlesex Water Service		3.67%		3.74%		3.54%	
Philadelphia Suburban		1.53%		1.53%		1.62%	
Average		2.73%		2.85%		2.88%	
Current Yield = Do/Po							

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Table 2 - 3						
Average Historical 5 & 10 Year Growth Rates						
Comparable Group 1996 - 2005						
	Earnings Growth	Dividend Growth		Sustainable Growth		Overall Average Growth Rate (%)
Year's	%	%		%		
1994	-1.80%	1.69%		3.36%		1.08%
1995	-9.59%	3.70%		2.19%		-1.23%
1996	3.77%	3.18%		2.18%		3.04%
1997	8.74%	1.16%		2.94%		4.28%
1998	2.22%	3.17%		2.53%		2.64%
1999	4.23%	2.73%		2.51%		3.16%
2000	4.24%	1.30%		2.47%		2.67%
2001	4.23%	2.26%		2.51%		3.00%
2002	8.32%	2.21%		2.92%		4.48%
2003	-11.39%	2.55%		1.48%		-2.45%
2004	20.74%	2.63%		2.50%		8.62%
2005	3.86%	2.53%		2.41%		2.93%
5 Year Average	5.15%	2.44%		2.36%		3.32%
10 Year Average	4.90%	2.37%		2.45%		3.24%
Overall Average Growth Rate:						3.28%

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				Table 2-4			
				San Jose Water Company			
				Comparable Group Forecasted Earnings			
				Growth Rates			
				First			
			ZACK'S	Call	S&P	Valueline	Reuters
Date of Data Drawn:			4/06	Not Avail	Not Avail	1/06	4/06
Company							
			%	%	%	%	%
American States Water Co.			6.00%	N/A	N/A	12.00%	4.50%
California Water Service			9.00%	N/A	N/A	8.50%	9.00%
Connecticut Water Service			N/A	N/A	N/A	N/A	N/A
Middlesex Water			3.50%	N/A	N/A	N/A	3.50%
Philadelphia Suburban			9.00%	N/A	N/A	13.00%	8.42%
SJW Corp.			N/A	N/A	N/A	N/A	N/A
Average:			6.88%	N/A	N/A	11.17%	6.36%
Overall Weighted Average							
of Forecasted Growth Rate			2.50%	0.00%	0.00%	3.05%	2.31%
Total Overall							
Weighted Average							
of Forecasted Growth Rates:				<u>7.86%</u>			
-							
TOTAL OVERALL AVERAGE GROWTH RATE EQUALS:			5.57%				

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			Table 2-5		
			San Jose Water Company		
			Discounted Cash Flow Model Summary		
			for the Comparable Group		
Component:					
<u>3 - Month Current Yield 1/</u>			2.73%		
Growth Rate		2/	5.57%		
Expected Yield		3/	2.88%		
ROE		4/	8.45%		
<u>6 - Month Current Yield 1/</u>			2.85%		
Growth Rate		2/	5.57%		
Expected Yield		3/	3.01%		
ROE		4/	8.58%		
<u>12 - Month Current Yield 1/</u>			2.88%		
Growth Rate		2/	5.57%		
Expected Yield		3/	3.04%		
ROE		4/	8.61%		
1/ Current Yield = Do/Po					
2/ Growth Rate = G *(Table's 2-3 & 2-4)					
3/ Expected Yield = D1/Po = Do/Po * (1 + G)					
4/ ROE = D1/Po + G					

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			Table 2-6				
			San Jose Water Company				
							Average
			Forecast	Forecast	Forecast	Forecast	for
			Date:	2007	2008	2009	2007 - 2009
	Description:			%	%	%	%
	30 - year Treasury Bonds	DRI - 4/06	5.02%	5.35%	5.73%		5.37%
2	10 Year Treasury Notes	DRI - 4/06	4.94%	5.14%	5.47%		5.18%

				Table 2-7		
				Risk Premium Analysis		
				Comparable Group		
				San Jose Water Company		
	Return					
Year	on	Average Yearly Yields		Risk Premium		
	Equity1/	30-Year	10 - Year	30 - Year	10 - Year	
	%	T - Bond	T - Bond	T - Bond	T - Bond	
		%	%	%	%	
1996	12.04%	6.70%	6.44%	5.34%	5.60%	
1997	11.87%	6.61%	6.35%	5.26%	5.52%	
1998	11.50%	5.58%	5.26%	5.92%	6.24%	
1999	11.03%	5.87%	5.64%	5.16%	5.39%	
2000	10.32%	5.94%	6.03%	4.38%	4.29%	
2001	10.60%	5.49%	5.02%	5.11%	5.58%	
2002	10.75%	5.42%	4.61%	5.33%	6.14%	
2003	9.68%	5.05%	4.02%	4.63%	5.66%	
2004	10.13%	5.12%	4.27%	5.01%	5.86%	
2005	10.46%	4.56%	4.29%	5.90%	6.17%	
	10 - Year Average Risk Premium			5.20%	5.65%	
	5 - Year Average Risk Premium			5.20%	5.88%	
APRIL DRI '06						
Forecasted Interest Rates for 2006-2008				5.37%	5.18%	
Projected Returns on Equity				30 - Year	10 - Year	
	10 Year Average:			10.57%	10.83%	
	5 Year Average:			10.57%	11.06%	

		Table 2 - 8	
		San Jose Water Company	
		Summary of Model Results	
		Comparable Group	
		Discounted Cash Flow Model	
	Growth Rate	5.57%	
	Three Month ROE	8.45%	
	Six-Month ROE	8.58%	
	Twelve - Month ROE	8.61%	
	DCF Average	8.55%	
		Risk Premium Model	
		5 - Year	10 - Year
	30 - Year Treasury	10.57%	10.57%
	10 - Year Treasury	11.06%	10.83%
	Risk Premium Ave	10.82%	10.70%
	Overall RP Average	10.76%	
	Return on Equity A	9.65%	

CHAPTER 3: FINANCIAL AND BUSINESS RISK

A. INTRODUCTION

In Chapter 2 of this report, DRA determined that the typical common equity investor expects an annual earned return of 9.65%. This determination is the result of a quantitative analysis using market – based financial data from a group of comparable water companies of comparable risk. In addition to this quantitative analysis, DRA assesses the level of business and financial risk faced by San Jose Water.

A company's total risk is the combination of business risk and financial risk. Business risk may be defined as the uncertainty inherent in the projections of future operating income relating to the fundamental nature of the company's business. Given the nature of the industry, the business risk of a regulated utility consists primarily of regulatory risk. Financial risk relates to the amount of debt in the capital structure; the larger the debt portion, the greater the financial risk.

B. DISCUSSION

1) Regulatory Risk

The number of regulatory mechanisms provided by the Commission virtually eliminates regulatory risks to San Jose Water. These include Balancing accounts for the Purchased Water, Purchased Power, and Pump Taxes; Memorandum Accounts for Catastrophic Events, and Waste Contamination; Memorandum Accounts for SDWA compliance; 50% Fixed Cost Recovery; and Construction Work in Progress in Rate Base.

1 In past proceedings water utilities have argued that they faced regulatory
2 and business risk as a result of the Commission imposing an earnings test on the
3 recovery of water supply balancing account offsets. DRA at many times has
4 challenged this argument, and the Commission has not made any specific risk
5 adjustment to the ROE based on the earnings test allegations of risk. DRA notes
6 this allegation is now moot on this issue, because the Commission has recently
7 eliminated the earnings test for the recovery of the water supply balancing account
8 under collections.

9 San Jose Water's perceived regulatory and business risk has been reduced as a
10 result of the elimination of the earnings test. The Commission has recently
11 eliminated the earnings test for the recovery of the water supply balancing account
12 under collections.⁷ The elimination of the earnings test will allow water utilities to
13 recover the full amount of the under collected balance regardless of the level of
14 utility earnings above the Commission authorized rate of return. The removal of
15 the earnings test will now allow the water utilities to further enhance profits and
16 has basically eliminated their perceived regulatory risk associated with the
17 recovery of water supply costs.

2) Financial Risk

Financial risk relates to the amount of debt used in the capital structure. The greater the ratio of debt to equity, the greater the financial risk. For regulated utilities, the percentage of debt and equity included in the capital structure has a direct impact on rates charged to ratepayers. A balanced capital structure has a positive impact on rates charged to ratepayers. A balanced capital structure should provide financial stability to a utility and produce reasonable rates for its customers, as well as continuity of service.

San Jose Water Company has proposed a capital structure consisting of long-term debt, and common stock. San Jose's projected common equity ratio for the years 2006 – 2008 averages 52.60%, which is slightly higher than the comparable groups' average of 49.45%. San Jose's projected long term debt ratio for the years 2006 – 2008 averages 47.40%, which is lower than the comparable group average of 49.99%; which would support the assertion that San Jose Water has lower financial risk than the comparable group of water utilities. See Table 2-1. Because San Jose Water isn't leveraged as highly as the average class "A" water utility; may indicate that it isn't entitled to receive some level of risk premium for its cost of equity. The company has requested to receive a 40 basis point size risk premium on its cost of equity, based on allegations that it is more risky than the larger Class water utilities. Based upon DRA's previously discussed findings; DRA's witness is recommending that San Jose should not be granted a 40 basis point risk premium.

(continued from previous page)
7- D.06-04-037, mimeo, p. 2.

3) Standard and Poor's Assessment

A company's total risk (business risk plus financial risk) is indicative of its overall financial integrity and ability to attract capital. Standard & Poor's (S&P, a rating agency), evaluates a company's total risk in order to assign a credit rating, which is a direct measure of capital attraction. S&P's evaluation includes a subjective analysis of business risk, including such things as managerial quality and regulatory environment. A quantitative analysis is also done, consisting of a group of financial ratios designed to measure how well a company can generate earnings and cash flow to meet its debt obligations. These ratios are a mix of measures relating to both business and financial risk. A rating of "AAA" through a "BBB" is considered "investment grade". Any rating lower than a "BBB" is considered speculative and more susceptible to adverse circumstances, or economic conditions.

S&P hasn't rated San Jose Water's long term debt; however, this fact has not impaired the company's ability to issue long term debt at favorable rates. For example, the company's weighted average cost of debt is in the range of 7.5%; which is comparable to the cost of other large utilities. (See Table 1-1).

C. CONCLUSION

San Jose Water appears to have relatively low business, and financial risk. The company does possess a reasonable amount long-term debt in its capital structure.

1 **CHAPTER 4: COMMENTS ON SAN JOSE WATER**
2 **COMPANY’S METHDOLOGY**

3
4 **A. INTRODUCTION**

5 San Jose Water has presented various models in support of its requested
6 ROE of 11.20%, in addition to the issues listed below. DRA does not agree with
7 the following components of San Jose Water’s analysis:

- 8 1. Increased Construction Expenditures,
9 2. Comparison to Gas Utilities,
10 3. Effect of Proposed Change in Balancing Account Recovery
11 4. Lawsuits from Ground Water Contamination

12
13 **B DISCUSSION**

14 **1) Increased Construction Expenditures**

15 San Jose Water is concerned that it must replace contaminated water supply
16 sources with no assurance of recovering the cost to make those replacements. The
17 company may have to invest in new treatment facilities to treat groundwater
18 contamination; increasing the risk that it faces.⁸ If investment in these facilities is
19 determined to be reasonable by this Commission, the capital projects will be
20 included in rate base and San Jose Water will receive a return on its investment. If
21 these additions are determined not be reasonable by this Commission, ratepayers
22 shouldn’t be burdened with either the cost of the addition, or any risk due to non-
23 recovery of the investment.

⁸ A. 06-01-004, pages. 43 thru 44.

1 **2) Comparable Group Selection**

2 San Jose Water uses a comparable group of water, electric and gas utilities for
3 its DCF, Risk Premium, and CAPM models. The DCF, Risk Premium, and
4 CAPM models are used to estimate the company's ROE. San Jose's comparable
5 group includes itself, as well in its comparable group of utilities.

6 **(a) Comparison to Electric and Gas**
7 **Companies**

8 The Commission has stated that water utilities should not be compared to
9 companies in other industries (D.01-04-034, p.13-14; D.90-02-042, p.38). Other
10 regulated utilities may appear to have similar characteristics to water, but are not
11 in fact comparable. In D.92-01-025, p.23, the Commission stated, "Due to the
12 revenue recovery mechanisms in place for water utilities, we find that water
13 utilities do not face the same overall risks as energy and telecommunications
14 utilities." In another proceeding for Park Water the Commission recently
15 dismissed Park Water assertions regarding comparability to the gas industry. In
16 D.05-12-020, the Commission states:

17 "We also find that natural gas rates of return are not
18 relevant for Apple Valley. The cost recovery and
19 market risks are totally dissimilar. Apple Valley failed
20 to provide any convincing evidence to support the
21 relevance of gas utility returns, and thus it failed to
22 meet its burden of proof on this portion of its cost of
23 capital showing. We therefore reject Apple Valley's
24 presentation on the returns of equity applicable to gas
25 utilities, while noting that Apple Valley does not base
26 its request on this study." (D.05-12-020, p. 11.)

27 Accordingly, consistent with recent and past decisions, the Commission should
28 also reject San Jose Water's use of electric, and gas utilities as a proxy group to
29 establish its ROE.

1
2 **3) Effect of Proposed Change in Balancing Account**
3 **Recovery**

4 At page 7 of San Jose Water's application; the company raises the concern
5 that the change in balancing account recovery (D. 03-06-072) will increase the risk
6 it faces, by impairing its ability to earn its authorized ROR. Surprisingly, San Jose
7 Water's ROE witness does not take into account a recent decision by the
8 Commission to eliminate the earnings test on balancing account recovery for
9 under collections. (See D. 06-04-037).

10 The Commission issued decisions which address balancing account dollars
11 recorded prior to November 29, 2001; see (D.02-12-055), as well as procedures
12 for recovery of balancing account dollars recorded subsequent to November 29,
13 2001: see (D. 03-06-072). The first decision ordered that all balancing account
14 dollars existing prior to November 29, 2001 may be recovered by the water
15 utilities, therefore eliminating some of the so called risk of impairing the
16 company's ability to earn its authorized ROR as claimed by San Jose Water. The
17 second decision adopted revised procedures for recovering dollars from balancing
18 accounts. In the determining the level of recovery for the under collection of
19 water utility balancing accounts, the application of the earnings test is essential to
20 prevent water utilities gaining any windfall when its returns already equal or
21 exceed the Commission's authorized rate of return. However with the recent
22 elimination of the balancing account earnings test, significantly increase the
23 opportunity for water utilities to maximize profits and have a greater opportunity
24 to meet or exceed their authorized rate of return. San Jose Water's argument on
25 increases in risk associated with the earnings test is moot.

26
27 **4.) Lawsuits from Ground Water Contamination**

28 San Jose asserts in pages 18 through 21 that it faces additional risk due to the
29 possibility of future lawsuits because of water quality. A utility facing this type of

1 litigation has a number of options available to reduce possible risk. Some possible
2 options are 1) recovery of a portion of the expenses associated with lawsuits
3 through insurance, 2) pursuit of legal action against the original polluters to
4 recover costs associated with the case, and 3) a memorandum account to record
5 costs associated with litigation.⁹ (If found to be reasonable, these costs will be
6 allowed in rates. If not found to be reasonable, they are not the ratepayers'
7 responsibility¹⁰ nor should any risk associated with them be borne by the
8 ratepayers.) These options all serve to reduce, or eliminate any risk that the
9 companies involved may face regarding litigation due to alleged contamination.

⁹ CPUC Resolution W-4089.

¹⁰ CPUC Resolution W-4089, page 4. "However, it has generally been the Commission's policy that litigation costs are not allowable for ratemaking if the utility is found negligent or admits
(continued on next page)

CHAPTER 5: COST OF LONG TERM DEBT

A. DETERMINATION OF LONG-TERM DEBT COST

The cost of long-term debt consists of interest and issuance expenses for all long-term bonds and notes, both outstanding and projected for the test period. The majority of the cost is derived from embedded costs, with the balance consisting of estimated cost for projected new issues. Since debt is a contractual arrangement, the terms for existing bonds are known. The costs of new debt issues are dependent, however, on forecasts of interest rates. The effective cost of long-term debt is computed as the ratio of the annual charge for the balance outstanding divided by the net proceeds of the balance outstanding.

B. SUMMARY OF RECOMMENDATIONS

DRA, has reviewed San Jose Water's application, and work paper's which outlined in detail the company's cost of long – term debt, and found the company's numbers to be reasonable. San Jose Water has indicated that it will be issuing \$15 million in new debt in 2006, \$12 million in 2007, and \$13 million in 2008.¹¹ The company has requested an overall cost of debt of 7.58%, 7.54%, and 7.52% for 2006, 2007, and 2008 respectively. See Chapter 1, Table 1-1 of this report.

(continued from previous page)
liability.”

¹¹ See A.06-01-004 WP 14-3 thru 14-6.

1 QUALIFICATIONS AND PREPARED TESTIMONY
2 OF
3 CLEASON WILLIS
4

5 Q.1. Please state your name and business address.

6 A.1. My name is Cleason Willis. My business address is 505 Van Ness Avenue,
7 San Francisco, California, 94102.
8

9 Q. 2. By whom are you employed and in what capacity?

10 A. 2. I am employed by the California Public Utilities Commission as a
11 Regulatory Analyst.
12

13 Q. 3. Please briefly describe your educational background and work experience.

14 A. 3. I graduated from the California State University of Hayward with a
15 Bachelor of Science Degree in Business Administration and Finance, and a Master
16 of Science Degree, in Public Administration, and Management.

17 I have been employed by the CPUC since 1987. From 1987 through 1989, I
18 was a member of the Special Economics and Research Branch, where I
19 participated in several general rate case analyses of major electrical utilities. I also
20 constructed an Elfin Financial Model, which was used to forecast a utility's capital
21 structure, cost of capital, and revenue requirement. From 1989 through 1992 I
22 worked in the Financial Auditing Branch where I performed various types of
23 audits of major electrical utilities. From 1992 through 1994 I was assigned to the
24 Telecommunications Branch where I had the opportunity to work on Monitoring
25 Reports, and 851 review of mergers. In 1995 through 2000 I was member of the
26 Financial Analysis and Investigations Branch, where I worked on various rate case
27 proceedings that ranged from General Rate Case proceedings to Balancing
28 Account proceedings. From 2001 through the present I have been assigned to the
29 Water Branch of DRA (The Division of Ratepayer Advocates), where I have

1 participated in various Gas rate proceedings, as well as marginal cost studies.
2 Since 2002 I've been assigned to DRA's Water Branch, where I have performed
3 cost of capital studies for class A water utilities.

4

5 Q. 4. What is your area of responsibility in this proceeding?

6 A. 4. I am responsible for Cost of Capital report for the San Jose Water Company
7 GRC.

8

9 Q. 5. Does this conclude your prepared testimony?

10 A. 5. Yes, it does.